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Supreme Court of the United States

October Term, 1936—No. 451

WILLIAM WHITLOCK BRUSH,
Petitioner,

against

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS, SECOND CIRCUIT.

PETITIONER'S BRIEF.

January 6, 1937.

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PETITIONER'S BRIEF.

Preliminary Statement.

A deficiency assessment on account of the tax upon his income for the year 1931 having been made against the petitioner, he appealed to the Board of Tax Appeals to secure a redetermination of the matter. He assigned as error the failure of respondent to accord exemption to so much of his income as represented salary paid him for services as Chief Engineer of the Board of Water Supply of the City of New York. The Commissioner having been upheld by the Board in an opinion by Mr. LEECH (R. 14-17), the petitioner appealed to the Circuit Court of Appeals for the Second Circuit. That Court affirmed, in an opinion *per* CHASE, J. (R. 43-49; 85 F. [2d] 32).

Jurisdiction.

This Court on November 16, 1936, granted a petition for a writ of certiorari, which had been applied for pursuant to Judicial Code § 240 (a) (U. S. C. Tit. 28, § 347).

Question Presented.

The supplying of water to Greater New York for use by the City itself and its inhabitants being a usual governmental function and an undertaking which cannot be either competently or safely left to private enterprise and having been conducted by the Government for over a century, should not the salary of a municipal employee serving as engineer to the Department of Water Supply be exempt from federal income taxes? The Petitioner contends that the Court below adopted an erroneous criterion for immunity, in that the Court laid down the test that the activity in question must be "necessary to its [the municipality's] existence as a government" (R. 47).

Statute and Regulations Involved.

Section 22 of the Revenue Act of 1928 (45 Stat. 791, 797), under the alleged authority of which the respondent acted in imposing the challenged tax, defines gross income as follows:

> "'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

Purporting to act pursuant to the statute referred to, the Bureau of Internal Revenue promulgated Regulations 74, Art. 643, reading as follows:

> "Art. 643. **Compensation of State officers and employees.**—Compensation paid to its officers and

employees by a State or political subdivision thereof for services rendered in connection with the exercise of an essential governmental function of the State or political subdivision, including fees received by notaries public commissioned by States, is not taxable. Compensation received for services rendered to a State or political subdivision thereof is included in gross income unless (*a*) the person receives such compensation as an officer or employee of a State or political subdivision, and (*b*) the services are rendered in connection with the exercise of an essential governmental function. The commissions of receivers appointed by State courts are subject to tax for 1928 and subsequent taxable years.

An officer is a person who occupies a position in the service of the State or political subdivision, the tenure of which is continuous and not temporary and the duties of which are established by law or regulations and not by agreement. An employee is one whose duties consist in the rendition of prescribed services and not the accomplishment of specific objects, and whose services are continuous, not occasional or temporary. Employees of universities receiving salaries paid in part or in whole from funds available under the Smith-Lever Act of May 8, 1914, who are officers or employees of a State, are not required to return as taxable income the salaries so received. This is also true with respect to the Act of August 30, 1890, relating to colleges for the benefit of agriculture and the mechanic arts, and to the Act of March 2, 1887, relating to agricultural experiment stations in such colleges. As to State contracts, see article 56."

The Government, in its communication to the petitioner, drew the following conclusions from Article 643 (R. 9):

"It is held that the supplying of water by water plants to the residents of a community constitutes the discharge of a proprietary function as distinguished from an essential governmental function, consequently the compensation of the officers and employees of such plants is subject to Federal Income Tax."

Facts.

The petition to the Board of Tax Appeals, which the petitioner duly filed, alleged as the reason for a determination in his favor *inter alia,* that (R. 5):

> "(b) The petitioner during the year 1931 as an officer of the City of New York, had supervision over the engineering details connected with the supplying of water to the City of New York for public purposes and the supplying of water to consumers thereof residing in the City of New York."

The answer denied this allegation (R. 13).

At the hearing before Mr. Leech of the Board of Tax Appeals, the Government admitted (R. 20):

> "The sole question before the Board is whether the supplying of water to the City of New York is a governmental function, * * *."

Mr. Brush took the stand in his own behalf and, after testifying to his appointment as Chief Engineer of Water Supply in the Department of Water Supply, Gas and Electricity of the City of New York, said that the Department's expenses were allocated two ways, *i. e.,* to the public service, and to the service of furnishing water to private consumers. He said (R. 21):

> "Of the expenses of the Department in 1931, 25.2% were allocated to public service, *i. e.,* service other than furnishing water to private consumers. The figure 25.2% was divided as follows: 11.8% to fire protection service; 6% to street cleaning and street flushing service; 5% to furnishing water for public buildings and public use without charge; .2% to the supervision of private water companies; 2.2% to the furnishing of water to communities other than the City of New York. Water is furnished to outside communities pursuant to statutes which specifically prescribe the charge that the City may make to such

other municipality. This charge is limited to the actual cost of collecting and delivering the water outside of the City."

He listed the following among his duties (R. 21-22)*:

1. the protection of the water supply from pollution;

2. the destruction of polluting matter that might have entered;

3. the determination of the amount of water to be drawn from various sources;

4. operations—including storage, transportation, distribution, treatment, delivery, maintenance of pressure, and control of use;

5. the maintenance of the high pressure fire service systems;

6. the supervision of personnel and expenditures;

7. the preparation of plans for improvements and extensions;

8. the preparation of agreements with outside communities for the supply of water from City sources, under special statutes, and the supervision of deliveries under such agreements, and of collections of charges agreed upon.

As to the financial operations of the Department of Water Supply, Mr. Brush stated that its revenues were turned over to the General Tax Fund of the City, whereas its expenses (including Mr. Brush's salary) were met from moneys raised by budget and tax levies (R. 22-23). He added (R. 27):

"The salary paid to me is in connection with my services rendered for all the boroughs constituting the Greater City of New York. There is no direct contribution by the other boroughs to the operation of the Water Supply System, that is, none of the

* See Greater New York Charter, §§ 468 *et seq.*

revennes derived from the sale of water is used as such for the maintenance or operation thereof."

Mr. Brush pointed out that the City's water supply system had already cost $480,000,000 (R. 23). This and related testimony was put in (R. 23-24)

> "to show that the furnishing of water to the City of New York involves projects of such magnitude and problems of such scope that it would be well nigh impossible for any private company to undertake them, and our point is that the City of New York in engaging in the furnishing of water, was engaging in an undertaking which it was compelled to engage in, because of the utter impossibility of securing future water supply for a city of this size, and in view of the problems which the City has to face through any private company.
>
> The Member: That is to say it is your position that the furnishing of water to a city the size of New York is a proposition of such magnitude, financially and otherwise, that it is necessarily a governmental function because it could not be done by private individuals?
>
> Mr. Weiner: That is one phase of it, yes, your Honor."

The method of figuring out what private consumers should pay the City for water was outlined at R. 27-28. Operations were shown to have been carried on at large annual losses ($7,000,000 in 1933 [R. 33]).

Mr. Brush stressed the connection between water supply and sewage disposal, and said (R. 32):

> "In my judgment as an Engineer there is very close relation between water supply and sewage disposal. The amount of water to be disposed of as sewage is almost exactly the amount of water which is furnished by the water supply for the community less the amount that is used for irrigation and simi-

lar purposes which does not reach the sewer. There is also a relation between the disposition of sewage and the sources of water supply. The question of how the sewage is disposed of has very vital effect on the question of the potability or purity of the water supply and its suitability for human consumption."

In addition to the foregoing facts, it should be remarked that the legislature has conferred upon the City of New York (N. Y. Laws 1905, ch. 724, § 35, as amended by L. 1928, ch. 525, § 5), as an incident of its power to construct and operate an aqueduct system, the duty to build and maintain highways and bridges in the vicinity of the reservoirs, and to give police protection to neighboring localities during the period of construction.

Opinions Below.

(1)

Mr. LEECH, writing for the Board of Tax Appeals, held (R. 16-17) that the petitioner had failed to establish his right to immunity because (1) in the operation of a water system a municipality is acting in its corporate or proprietary character and not in a governmental capacity, and (2) the magnitude of the undertaking of supplying water to the inhabitants of New York City was not a feasible basis for distinguishing the instant case from the general rule.

(2)

In delivering the opinion of the Circuit Court of Appeals, Judge CHASE, after summarizing the facts and the arguments put forward by petitioner, and after acknowledging the magnitude of the undertaking, said (R. 46):

"* * * but it is not equally clear that private enterprise adequately encouraged could not do it as well.

> To say that it could not in the light of common knowledge as to modern private achievement in business on a vast scale would seem to deny probability. In any event such an assertion is not adequately supported by evidence in this record."

He then went on to state that while water was indispensible to the inhabitants, the conduct of a municipal water supply system is not "an activity necessary to its [the City's] existence as a government". He added (R. 47-48):

> "On the contrary, due regard must be had to distinguish between those activities which, though impressed with a public interest and sometimes, even often, performed by government are nevertheless done in a proprietary capacity in supplying to the public for a direct charge what it could, and otherwise would, procure from private sources and those services which have become the usual activities of government because purely governmental power is in some degree essential to their performance."

Outline of Argument.

Upon the record as outlined above we propose to argue as follows:

1. The supply of pure water, in adequate amounts, to urban centers of population is a usual governmental function. It has been so traditionally, and a marked tendency is presently discernible in municipal administration to shift from private to public ownership of waterworks, thus accentuating the tradition.

2. The taxation of the petitioner's salary impedes and burdens the municipality in performing governmental functions.

POINT I.

The supply of pure water, in adequate amounts, to urban centers of population is a usual governmental function. It has been so traditionally, and a marked tendency is presently discernible in municipal administration to shift from private to public ownership of waterworks, thus accentuating the tradition.

1. The test to be applied is whether the supply of water is a "usual governmental function".

It will be recalled that in *Helvering* v. *Powers*, 293 U. S. 214 (1934), this Court held the salary of one of the trustees of the Boston Elevated Railway Company, to be subject to federal income taxes, although he was appointed by the Governor under a special act of the Commonwealth which provided for the operation of the company under an arrangement whereby deficiencies in its income were to be made good by the Commonwealth for a limited period. The claim to exemption was tenuous in the extreme for the Company paid the salary, and the case is remote from the instant case on its facts. It possesses importance, however, by reason of the admonition to the States (p. 225) that they cannot

> "withdraw sources of revenue from the federal taxing power by engaging in businesses which constitute a departure from *usual* governmental functions and to which, by reason of their nature, the federal taxing power would normally extend." (Italics ours.)

And of the Treasury Regulations under which the imposition of the tax was justified, the Court said (p. 224):

> "The Treasury Regulations, manifestly in an effort to interpret and apply that limitation, provide for

> exemption from taxation of compensation paid by a State or political subdivision to its officers and employees only in case their services are rendered 'in connection with the exercise of an *essential* governmental function'. Treas. Reg. No. 69, Art. 88; No. 74, Art. 643; No. 77, Art. 643. But the Treasury Department could not by its regulation either limit the provisions of the statute or define the boundaries of their constitutional application." (Italics ours.)

The rejection of "essential" as a test is thus manifest, as well as the intent to formulate a new criterion of immunity, and to effect a supersession of the tests formerly prevailing. For in *Flint* v. *Stone Tracy Co.*, 220 U. S. 107 (1911), this Court had differentiated between "those operations of the States *essential* to the execution of its governmental functions, and which the State can only do itself, and those activities which are of a private character".

The substitution thus made of "*usual* governmental functions" for the formerly prevalent phrase "*essential* governmental functions" seems to us one of the most noteworthy features of the *Powers* case; so that it is surprising that the Court below overlooked the change and deemed it its duty to confine the immunity of city employees against the federal taxation of their salaries to employees engaged in functions the suspension of which would suspend government itself.

The change from "essential" to "usual" was not merely an unintentional change in verbiage, as the Solicitor General would have us believe (Brief in opposition to petition for certiorari, p. 11); for this Court reiterated in substance the *Powers* formula in *United States* v. *California*, 297 U. S. 175 (1936), saying (p. 185):

> "Hence we look to the activities in which the states have traditionally engaged as marking the boundary of the restriction upon the federal taxing power."

2. That it has been consistently regarded as a sovereign or governmental function from an early date is clear under the authorities.

The cases clearly show that the operation of a waterworks is a true governmental function, and that this attitude on the part of the Courts has been adhered to with rare consistency.

An early case is *New Orleans* v. *Morris*, 105 U. S. 600 (1882), in which the lower Court had held unconstitutional, under the obligation of contracts clause, a statute exempting from execution the stock of its waterworks owned by the City. This Court reversed and found an adequate justification for the statute in public policy, stating (p. 602):

> "• • • we think it quite clear that these works were of a character which, like the wharves owned by the city, were of such public utility and necessity, that they were held in trust for the use of the citizens. In this respect they were the same as public parks and buildings, and were not liable to sale under execution for ordinary debts against the city."

Similar expressions will be found in *New Orleans Waterworks Company* v. *Rivers*, 115 U. S. 674, 681-682 (1885).

In *Columbus* v. *Mercantile Trust Co.*, 218 U. S. 645 (1910), the Court exalted water supply to the rank of one of the highest police duties entrusted to a city, saying (p. 658):

> "No higher police duty rests upon municipal authority than that of furnishing an ample supply of pure and wholesome water for public and domestic uses. The preservation of the health of the community is best obtained by the discharge of this duty, to say nothing of the preservation of property from fire, so constant an attendant upon crowded conditions of municipal life."

This Court's description of water supply as the highest of police duties is of great significance for our present purposes. For it allows us to distinguish readily such cases as *South Carolina* v. *United States*, 199 U. S. 437 (1905), and *Ohio* v. *Helvering*, 292 U. S. 360 (1934). In the latter case this Court said (p. 369):

> "If a state chooses to go into the business of buying and selling commodities, its right to do so may be conceded so far as the Federal Constitution is concerned; but the exercise of the right is not the performance of a governmental function, and must find its support in some authority apart from the police power. When a state enters the market place seeking customers it divests itself of its *quasi* sovereignty *pro tanto*, and takes on the character of a trader, so far, at least, as the taxing power of the federal government is concerned."

But in the instant case, the municipality is, by definition, not entering the market place seeking customers but is performing activities for which authority need not be sought apart from the police power, for those activities are the *highest* of police duties.

More recently, this Court in *Ashton* v. *Cameron County Water Improvement District*, 298 U. S. 513 (1936), after stating that the respondent was organized to furnish water for domestic and irrigation uses, said (pp. 527-528):

> "It is plain enough that respondent is a political subdivision of the State, created for the local exercise of her sovereign powers, and that the right to borrow money is essential to its operations."

The New York cases are in harmony with the foregoing. Thus in *City of Rochester* v. *Town of Rush*, 80 N. Y. 302 (1880), the plaintiff-respondent sought to have those parts of its waterworks located in the defendant town declared

exempt from taxation. Relief was denied because the plaintiff had not proceeded under the right statute, but the Court pointed out (p. 307) that the waterworks project had been "executed for the public good, and the property therefore held for public purposes". It consequently could not be seized in the foreclosure of a lien for taxes or otherwise. And after citing a case holding a bell-tower exempt from execution in mechanic's lien proceedings (*Leonard* v. *Brooklyn*, 71 N. Y. 498 [1877]), this Court said (p. 308):

> "A bell-tower, from which the alarm of fire may be sounded, cannot be considered more necessary in the scheme of municipal affairs and good government than water-works, which will furnish the means of extinguishing the fire when its existence is announced."

See also *Matter of Village of Massena* v. *St. Lawrence Water Co.*, 126 N. Y. Misc. 524, 214 N. Y. Supp. 113 (Sup. Ct., 1926), where the Court said (pp. 529-530):

> "The furnishing of a supply of water not only as a precaution against fire and sanitary purposes but also for individual use has always been recognized as a proper public and municipal purpose based upon the inherent and palpable necessity of the case and customs of thickly-settled communities. A municipality exercises this power in its legislative and governmental capacity."

3. The necessity of public operation of waterworks is so widely recognized that such operation has become usual, with private operation rare in practice and confined to the smaller cities.

Public operation of waterworks in the large cities has, as time goes on, been more and more widely recognized as necessary. The calamitous consequences of a failure of the

water supply have converted cities to public operation because the immediacy of control which it gives reduces the chances of stoppage. Moreover, the time consumed in the construction of waterworks, especially when the sources to be tapped are remote, makes it always speculative whether a privately organized company can keep itself in a sound financial state while waiting for earnings to begin. There is also the risk that the eagerness of private companies to show profits might well make them postpone programs of expansion until forced into adopting them by the occurrence of some public catastrophe.

The wide acceptance of these doctrines as directing forces in shaping municipal policy is shown by the statistical charts in the *Municipal Index and Atlas.* In its 1934-35 edition, a list is given on pages 120-132 of political units (of 10,000 population) which are served by waterworks. Out of 969 separate waterworks 779 or 80.39% are municipally owned and operated, and only 190 or 19.61% are privately owned and operated. An examination of earlier editions of this reference work shows a steady rise in the percentage of municipally owned and operated waterworks.

Further statistics in the brief filed by the Corporation Counsel of the City of New York as *Amicus Curiae* show that it is practically an invariable thing for every city, upon reaching the 100,000 class, to shift from private to public ownership of waterworks.

4. In defining "usual governmental function", the Courts should not confine their attention to the situation prevailing when the Union was formed.

Nor have the Courts been averse to recognizing the duty to look at current developments, and to expand the concept "usual governmental function" accordingly.

Thus in *Hoskins* v. *Commissioner of Internal Revenue*, 84 F. (2d) 627 (5th Circ., 1936), the Court took pains to point out that in considering whether a given activity (*i. e.*, running a cafeteria in connection with a public school) was properly a governmental function and those engaged in it properly exempt from federal taxation, it should consider actualities and not be bound by views prevailing in times past.

5. The analogy of the tort cases is impertinent and misleading.

We are well aware that the conduct of waterworks has been held in New York to be an activity carried on by cities in their private or proprietary, rather than in their governmental capacity. *Oakes Manufacturing Co.* v. *City of New York*, 206 N. Y. 221 (1912); *Canavan* v. *City of Mechanicville*, 229 N. Y. 473 (1920). But these decisions were both tort cases, where considerations of policy are widely different from those pertinent to the case at bar. Exemption from liability in tort might have led to widespread individual suffering and other consequences of a deplorable character. The Courts might well have decided that to leave uncompensated all persons injured through the negligent operation of waterworks would produce more widespread social evils than would flow from holding cities liable to persons injured.

Radically different considerations assume control when the discussion shifts to the matter of tax exemption of waterworks' employees from federal taxes. To deny exemption hinders the performance of what this Court regarded as the highest of police duties (*Columbus* v. *Mercantile Trust Co., supra*) by either leaving employees dissatisfied with reduced salaries or cities burdened with the duty of increasing those salaries to levels adequate to

leave a fair and just net salary after paying taxes. Consequently, the analogy of the tort cases should not mislead the Court.

That their traditional dichotomy is not universally valid has been acknowledged by this Court itself. In *Trenton* v. *New Jersey*, 262 U. S. 182 (1923), wherein the plaintiff in error argued that property owned in its private or proprietary capacity could not be summarily taken from it by legislative act without violating the Fourteenth Amendment whatever might be the rule as to property owned in its sovereign or governmental capacity, the Court said (pp. 191-192):

> "The basis of the distinction is difficult to state,* and there is no established rule for the determination of what belongs to the one or the other class. It originated with the courts. Generally it is applied to escape difficulties, in order that injustice may not result from the recognition of technical defenses based upon the governmental character of such corporations. But such distinction furnishes no ground for the application of constitutional restraints here sought to be invoked by the City of Trenton against the State of New Jersey. They do not apply as against the State in favor of its own municipalities."

6. The petitioner's contentions do not lead to a withdrawal of any field from federal taxation. The field we are concerned with has never previously been invaded by the federal government.

The cautionary language of the *Powers* case that the States cannot withdraw sources of federal revenue by engaging in businesses usually carried on by private citizens,

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* It was stigmatized as "largely a matter of legal acrobatics" in *Northrup* v. *City of Jackson*, 273 Mich. 20, 24, 262 N. W. 641 (1935).

has no pertinence here. The salaries of water supply employees have *never* been held taxable by this Court, and no immunity is now claimed which has not been tacitly recognized for a century.

It is interesting to note that immunity was expressly recognized as late as 1925, the date of the argument in *Metcalf & Eddy* v. *Mitchell,* 269 U. S. 514 (1926). The case was here on cross writs of error. Of the Collector's writ, this Court said (p. 519):

> "The court found that the two items of income involved in No. 376 were received by one of the plaintiffs in error as compensation for his services as the incumbent of an office created by statute; in one case as chief engineer of the Kennebec Water District, a political subdivision of the State of Maine, and in the other as a member of the Board of Engineers of the North Shore Sanitary District, a political subdivision of the State of Illinois. The Collector does not press his writ of error in this case, and we therefore dismiss the writ."

7. That revenues are derived from the municipal waterworks is of no consequence.

It is hardly necessary to add that while the water supply enterprises of New York City produce some revenue (though without a net profit), that circumstance does not defeat the right to immunity from federal taxation which the petitioner now claims.

In *Commissioner of Internal Revenue* v. *Ten Eyck,* 76 F. (2d) 515 (2nd Circ., 1935), where the salary of the Chairman of the Albany Port District Commission was held exempt from federal taxation, the Court said (p. 519):

> "It is the entrance into a trade enterprise that distinguishes these cases, relied upon by the petitioner. It cannot be maintained that there is involved in the instant case a trade or business, entered

the contention to that effect is refuted by its mere statement."

We venture to suggest that the position taken by the respondent in the case at bar is not without perils to the federal government itself. For if the government's contentions are upheld, the various states in which the Tennessee Valley Authority carries on its operations might well seek to tax its revenues and its real estate, on the ground that to do so would not impede any activity essential to the existence of the federal government *as a government.* Such an extension of the power of the States to tax federal agencies would appear to be sanctioned by the logic of the decision we are so earnestly asking this Court to reverse.

Conclusion.

The order of the Circuit Court of Appeals should be reversed, and the cause remanded to the Board of Tax Appeals with directions to redetermine the petitioner's income tax for the year 1931 pursuant to the prayer of the petition heretofore filed with the Board.

Dated, New York, N. Y., January 6, 1937.

Respectfully submitted,

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